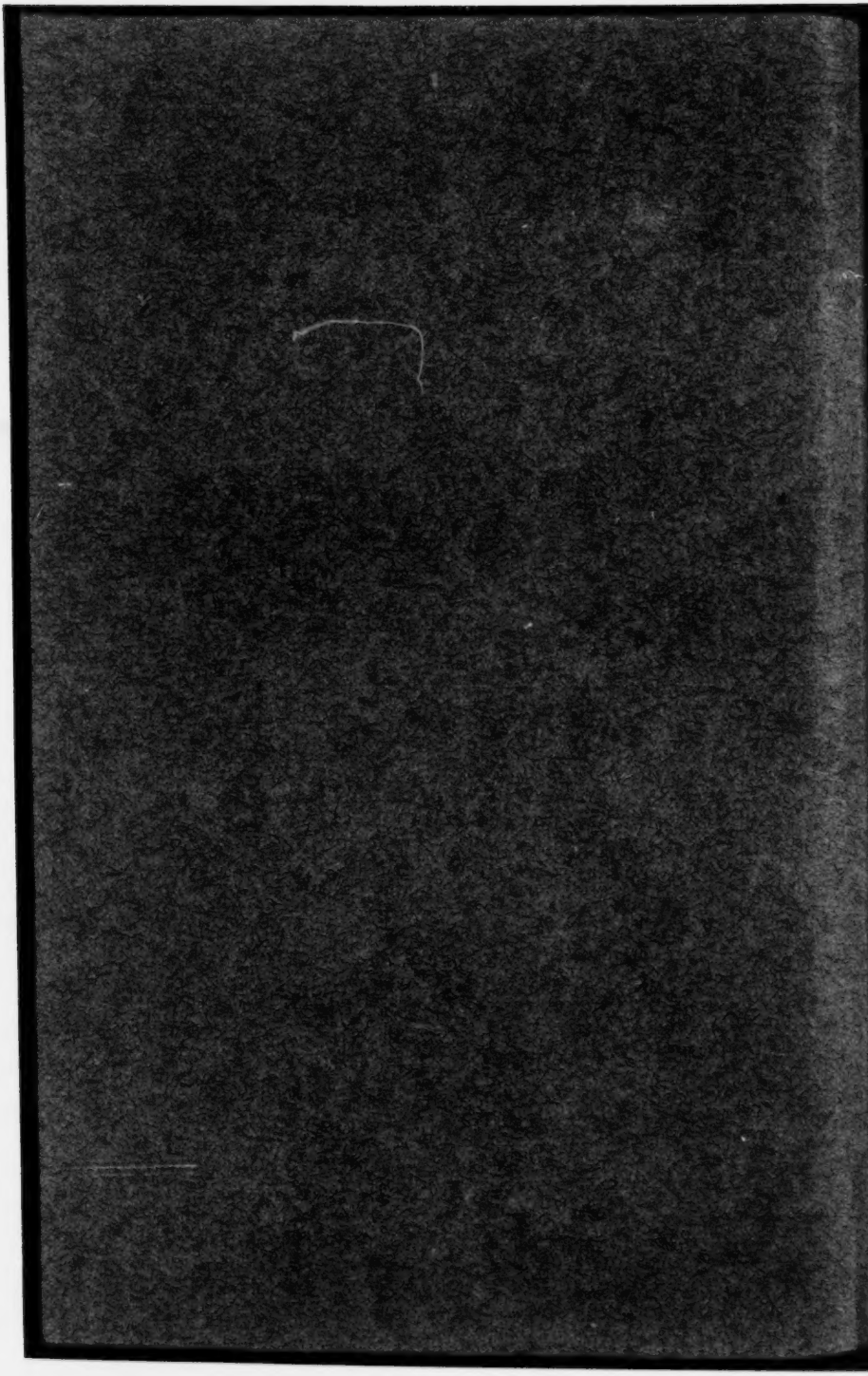
In the Supreme Court of the United States



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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 824

KATIE M. HOWELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 825

ESTATE OF J. H. HOWELL, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 15–23) is not reported. The opinion of the Circuit Court of Appeals (R. 69–75) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 8, 1944 (R. 75). The petition for writs of certiorari was filed March 29, 1944.[1] The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A contract executed concurrently with an oil and gas lease provided that the lease was to be held in escrow and was not to be delivered unless the lessee started drilling a well on the property by a specified date. The question is whether, in computing the taxable percentage of the gain realized upon a sale of the leasehold interest under Section 117 of the Internal Revenue Code, the holding period is to be measured from the date the lease was executed or from the date it was delivered by the escrow agent upon commencement of the drilling.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 117. CAPITAL GAINS AND LOSSES.
>
> (a) *Definitions.*—As used in this chapter—
>
> * * * * *

[1] These are companion cases involving identical issues, the returns having been filed on the community property basis. The cases were consolidated for hearing and disposed of as one case by both the Tax Court (R. 15) and the Circuit Court of Appeals (R. 63–65), and by stipulation (R. 76) only the record in No. 824 has been printed.

(2) *Short-Term Capital Gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months * * *

* * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months; 66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

* * * * *

(26 U. S. C., Sec. 117.)

STATEMENT

On October 6, 1937, one Ferguson entered into a contract with J. H. Howell, the petitioner's husband, which recited that Ferguson as party of the first part was the owner of certain land in Wichita County, Texas, and that Howell as party of the second part desired to drill a well on the land (R. 16, 44–46). The contract then provided (R. 16–17, 45–46):

> Now, Therefore, for and in consideration of the payment by said Second Party herein of the sum of $1.00, and other covenants and agreements hereinafter set forth, said First Party agrees to execute and place in escrow in the First National Bank of Wichita Falls, Texas, oil and gas lease covering the above described tract of land, in favor of said Second Party; and said Second Party hereby agrees that he will, on or before the 21st day of November, 1937, commence the actual drilling of a well on the tract of land above described, said well to be drilled with due diligence to a depth of 4,000 feet, or to a sufficient depth to test what is known as the K–M–A deep sand. * * *
>
> The lease mentioned herein is to be for a period of three years, with annual rental of $1.00 per acre; and said lease is to be delivered to said second party at the time said well is actually started.

On the same date, October 6, 1937, Ferguson executed an "Oil and Gas Lease" in favor of Howell, covering the land described in the above contract, substantially in accordance with the provisions of the contract (R. 17, 39–44). The lease, among other things, obligated the lessee to deliver to the lessor one-eighth part of the oil and gas produced, and contained the following additional provision (R. 17, 43):

> As a further consideration, lessee herein agrees that he will commence the actual drilling of a well on or before November

> 21st, 1937, on the above described acreage; said well to be drilled to a depth sufficient to test the 4,000 foot or K–M–A deep sand, according to contract attached hereto and made a part hereof.

The lease was not placed in escrow with the First National Bank, but by mutual consent was left with one Gray as escrow agent. Gray was office manager for Ferguson and also an independent oil producer. Gray was instructed to return the lease instrument to Ferguson if no well was actually started by November 21, 1937. The parties also agreed that, if and when the lease became valid upon commencement of the drilling of a well within the specified time, Gray should receive an interest in 20 acres out of the lease. (R. 17.)

On October 26, 1937, Howell entered into an agreement with Consolidated Oil Company whereby he agreed to convey to Consolidated an undivided three-fourths interest "in the 'acreage' covered by * * * contract" of October 6, 1937, between himself and Ferguson, in consideration of a cash payment and the assumption by Consolidated of Howell's obligations under the contract (R. 18, 52–53).

On November 16 or 17, 1937, a well was actually started and on the same day Gray delivered the lease to Howell (R. 18). On November 19, 1937, the lease and contract were filed for record in the office of the county clerk for Wichita County,

Texas (R. 17). On the same day, November 19, 1937, Howell by written assignment reciting that "the said lease and all rights thereunder or incident thereto are now owned" by him, conveyed to Consolidated an undivided three-fourth interest in the lease (R. 18, 53–54). Also on that same day, Howell and Consolidated assigned to Gray their interest in the lease with respect to a certain tract containing 20 acres (R. 18, 56–58).

On April 10, 1939, Howell and Consolidated sold their combined interest in the lease to Buffalo Oil Company for $700,000 cash (R. 18–19, 56–58).

The income tax returns filed by Howell and his wife on the community property basis disclosed a community profit of $160,146.67 derived from the sale of their interest in the Ferguson lease. Only 66⅔ percent of this gain was reported as taxable income, on the theory that the amount so reported represented a long-term capital gain derived from the sale of a capital asset held for more than 18 months, but not more than 24 months. (R. 19–20.) The Commissioner determined that the amount reported represented short-term capital gain, taxable to the extent of 100 percent. The Tax Court sustained the Commissioner's determination (R. 23–24). The Circuit Court of Appeals affirmed (R. 75).

ARGUMENT

This case turns upon the application of the familiar principle that ownership of property

passes when the contracting parties so intend. It presents neither a conflict nor a question of general importance.

1. The only issue presented is the length of time the leasehold interest sold in 1939 had been "held" within the meaning of Section 117 of the Internal Revenue Code. The question narrows itself to one of when Howell acquired ownership of the lease, since within the meaning of the statute "to hold property is to own it." *McFeely* v. *Commissioner,* 296 U. S. 102, 107. See also *Helvering* v. *San Joaquin Co.,* 297 U. S. 496, 499. It has been uniformly held that the holding period of capital assets acquired by contract commences when ownership is acquired, and that the time of acquisition of ownership depends upon the intention of the parties as gathered from the contract and the surrounding circumstances. *Shillinglaw* v. *Commissioner,* 99 F. 2d 87 (C. C. A. 6th), certiorari denied, 306 U. S. 635; *Commissioner* v. *C. A. Sporl & Co.,* 118 F. 2d 283 (C. C. A. 5th); *Shattuck* v. *Helvering,* 119 F. 2d 902 (C. C. A. 2d); *Sommers* v. *Commissioner,* 63 F. 2d 551 (C. C. A. 10th). Cf. *Commissioner* v. *Cummings,* 77 F. 2d 670 (C. C. A. 5th); *Bothwell* v. *Commissioner,* 77 F. 2d 35 (C. C. A. 10th).

The record fully supports the conclusion of the courts below that Howell's ownership of the lease was conditional upon the starting of a well by November 21, 1937, and that he did not acquire

ownership until that condition was fulfilled on November 16 or 17, 1937. The contract executed on October 6, 1937, concurrently with the lease provided that the lease was to be placed in escrow, that Howell should commence drilling a well on or before November 21, 1937, and that the lease was to be delivered "at the time said well is actually started" (R. 16–17, 44–46). These provisions are unequivocal and leave no room for doubt that the parties intended ownership of the leasehold interest to pass only if and when the stipulated condition precedent was performed. Had they intended ownership to vest immediately upon execution of the lease, as petitioner contends, the separate contract would have been entirely superfluous.[2]

The contract was given full effect by the parties. The lease was placed in escrow with instructions that the escrow agent return it to the lessor if a well was not started by the specified date (R. 17). On November 16 or 17, 1937, a well was started

[2] At least two important effects of the separate contract may be noted: (1) Under the lease the lessee had the option of paying a stipulated annual rental in lieu of commencing a well (R. 41–42), whereas under the contract he was obligated to commence drilling as a condition precedent to obtaining delivery and ownership of the lease (R. 45–46); (2) since under Texas law an oil and gas lease operates as a present sale of the oil and gas in place (*Burnet* v. *Harmel*, 287 U. S. 103), the contract postponed such sale until ownership of the leasehold interest passed to the lessee upon performance of the condition.

and the escrow agent delivered the lease (R. 18). Prior to that event Howell had conveyed to Consolidated Oil Company a three-fourths interest in his "contract" (R. 18, 53); only after the condition precedent was performed and the lease delivered could he assign to that company a three-fourths interest in the lease itself, which he did by an instrument reciting that "said lease and all rights thereunder or incident thereto are now owned" by him (R. 18, 54). And it was not until after the the condition was performed that the lease was recorded (R. 17), and that Howell and Consolidated joined in a conveyance to Gray, the escrow agent, of a 20-acre interest in the lease (R. 18, 47–49).

2. Petitioner asserts (Pet. 5–7) conflict with *Burnet* v. *Harmel,* 287 U. S. 103, and related authorities. Those cases are not concerned with the issue here presented. They involve consideration of *what* economic interests pass to a lessee of oil and gas lands, rather than *when* those interests pass. None of them deals with the holding period. As the court below pointed out, petitioner fails to distinguish between an absolute and a conditional lease; between a contract right to enter upon the land in order to perform a condition precedent to ownership of the lease, and the lease-

hold interest itself.[5] The asset which was sold in 1939 and from which the capital gain was derived was not the right to enter upon the land to perform the condition, but the leasehold interest. That asset was not acquired and "held" until the condition was performed and the lease delivered by the escrow agent.

3. The decision below is not, as petitioner asserts (Pet. 12), in conflict with *McFeely* v. *Commissioner, supra.* On the contrary, the court below in its opinion properly relied upon that case. This Court there held that to "hold" property is to own it, and that property acquired from a decedent through intestacy or general bequest was owned, and therefore "held," from the date of the decedent's death. Where, as here, property is acquired by contract, the holding period likewise commences when ownership is acquired; in such case, however, the date of acquisition of ownership necessarily depends upon the intention of

[5] It is axiomatic that where a written instrument is executed and placed in escrow for delivery at a future date on performance of a condition, the date of delivery marks the effective date of the instrument. Restatement of the Law of Contracts, Secs. 101 and 103. This familiar principle is well recognized in Texas, where the contract in the instant case was executed and was to be performed, and an oil lease is no exception to the rule. *Norman* v. *Wilson*, 41 S. W. 2d 331 (Tex. Civ. App.); *Bott* v. *Wright*, 62 Tex. Civ. App. 632. Cf. *Sutton* v. *Commissioner*, 95 F. 2d 845, 848–849 (C. C. A. 10th).

the contracting parties. *Shilinglaw* v. *Commissioner, supra; Shattuck* v. *Helvering, supra.* Cf. *Helvering* v. *San Joaquin Co., supra.*

4. Petitioner's reliance (Pet. 8–9) upon G. C. M. 2270, VI–2 Cum. Bull. 216 (1927), is misplaced. It dealt not with the issue here involved, but with allowances for a depletion, and the purpose, the nature, and the effect of the escrow agreement there considered were different. Moreover, even if it were applicable here, it would lack the force of a regulation and would not, as petitioner suggests, represent an established administrative construction. Cf. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455.

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. The case is not of general importance and turns upon its own particular facts. The petition should be denied.

Respectfully submitted.

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